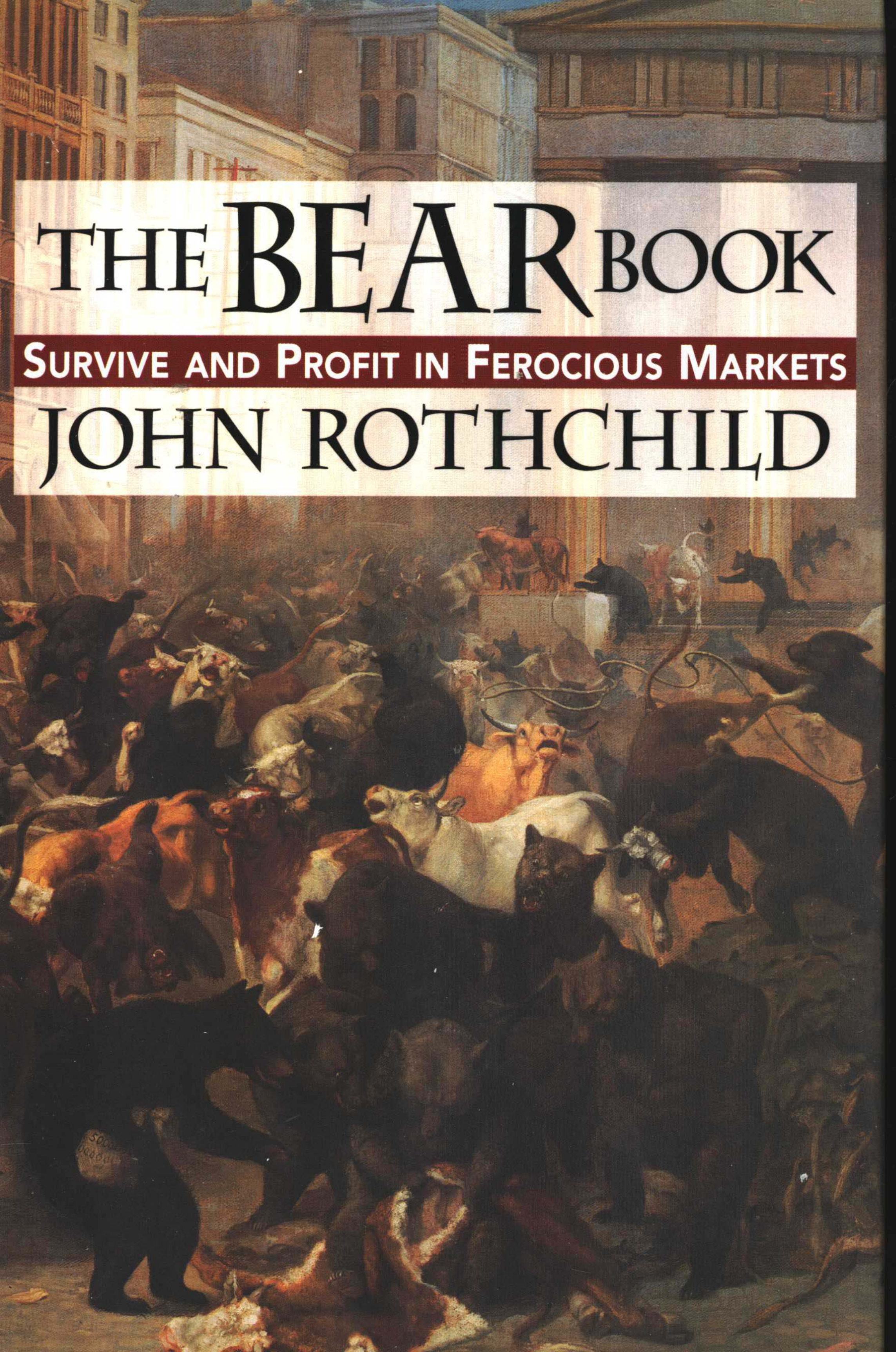
THE BEAR BOOK

SURVIVE AND PROFIT IN FEROCIOUS MARKETS

JOHN ROTHCHILD



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PART ONE

Bears Will Rise Again

Are Stocks Really That Great?

EVERY BROKERAGE HOUSE and most financial planners invite a new client—let's assume it's you—to fill out a questionnaire about your income, net worth, financial goals, and other intimacies you'd never share with your friends. Your answers are run through a computer and, in minutes, you get a printout of how much money you'll need in the future and the best way to accumulate it—most likely, by investing your seed capital 100 percent in stocks. This recommendation is based on the assumption that stocks will return 10 to 11 percent a year, as they have throughout the twentieth century.

Here's the catch that's often overlooked: stocks don't go up 10 to 11 percent *every year*. In fact, after several years of going up faster than 10 to 11 percent, they can be expected to go up slower than 10 to 11 percent, and perhaps they could even go down! At some point, they'll enter a bear market, where a stretch of losses will balance out the latest stretch of gains.

The 10 to 11 percent annual return from stocks is a twentieth-century phenomenon. Throughout the nineteenth century, stocks returned around 6 percent a year. If ancient history repeats itself, who's to say that stocks in the twenty-first century won't revert to their longer-term performance, throwing every financial plan out of whack? If that happens, all the planners, pension managers, and stockbrokers will have overestimated their clients' wealth at retirement by a wide margin. Instead of the condo in Lake Tahoe, tomorrow's retirees will get the trailer park on the prairie.

As of this writing, and after years of outsized gains, stock prices would have to drop in half, or undergo several years of subpar returns to bring them back into the normal range of 10 to 11 percent profitability. This would inconvenience many people who are relying on stocks to underwrite their retirement, but stocks don't care when anybody retires. They have their own schedule.

Scrape inflation off stocks, and much of the wealth they're credited with producing for investors disappears, even without a bear market. Bob Prechter insists stocks are overrated. Prechter operates out of Gainesville, Georgia, far from Wall Street. Many bearish commentators are camped in the hills where office rent is cheaper and they aren't surrounded by bulls.

Prechter's a Yale grad: opinionated, cogent, well-informed, unflappable. The kind of guy you like to see in an airplane cockpit. (See Bears' Hall of Fame, page 225.) He was a raging bull in 1982. The Dow was at 900; he said it would hit 3,900, and nobody believed him. When the Dow hit 8,000 in 1997 he said it would drop to below 3,000 eventually, and nobody believes him. He's been bearish far too long to hold an audience, but few pessimists are better informed on the subject of how stocks fail to live up to their reputations.

In terms of real purchasing power, Prechter notes, owning the Dow Jones Industrials since 1966 has resulted in zero gain through 1994! The Dow itself advanced from 1,000 to 3,978 in 1994, but the cash you received from selling a share in the Dow that year bought less merchandise than the cash you got from selling a share in the Dow at 1,000 twenty-eight years earlier.

The true Dow has been stuck in a rut in spite of Bill Gates, Sam Walton, and other innovators who have given America its competitive edge. "Consider," Prechter muses, "the implications of a stock market index that made no real progress in nearly three decades, and which is nevertheless historically overvalued."

Prechter argues stock market returns are overstated in other ways. The major averages don't reflect the damage done to smaller stocks in certain situations. The historic returns don't include the many companies that shut their doors and disappear from the listings. The typical portfolio in 1929 included names like Auburn, Cord, Missouri-Pacific, Pierce-Arrow, and Stutz, all of which landed on the trash heap of equities. These total losses surely would drag down the returns from owning stocks, because the owners of those particular shares ended up with zilch.

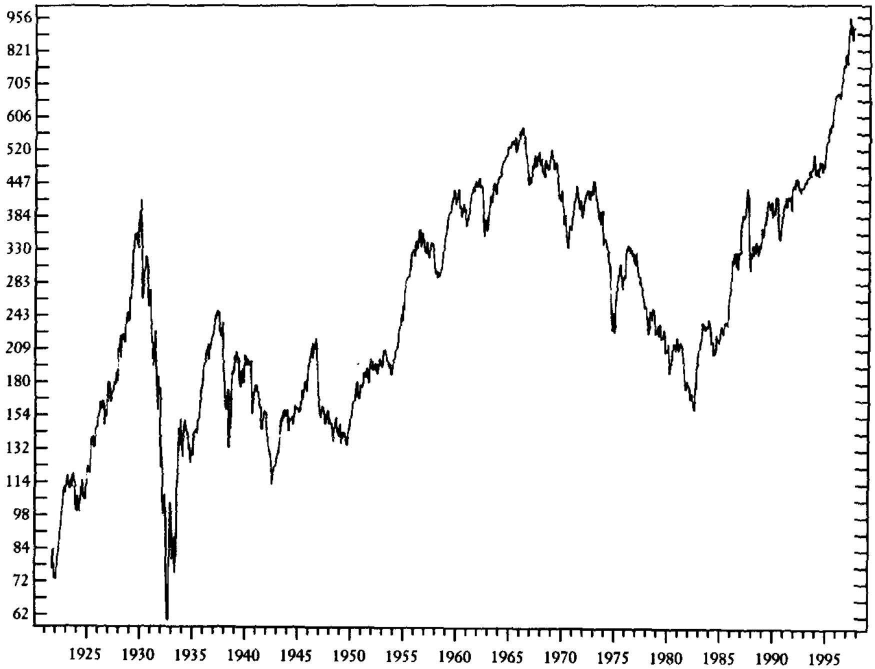
In any event, the much advertised 10 to 11 percent annual payoff is an imaginary return, from some other planet that has no taxes and no inflation.* For a less fanciful accounting of gains on earth, Marty Zweig has created the Deflated Dow Jones Industrials (Exhibit 1).

A successful market timer and chronic worrier who manages more than $4 billion with the primary goal of not losing a penny of it, Zweig started with the famous Dow average, then subtracted for inflation and adjusted for deflation. The result is the actual buying power of dollars invested in stocks over time.

Viewed in this harsher light, stocks have performed quite differently than the raw data suggest. In the 1920s, they enriched investors as advertised, because inflation was minimal in that decade.

* The real returns from competing investments such as bonds or savings accounts are also subverted by inflation, so stocks are not alone in this leaky boat.

Exhibit 1 Deflated Dow Jones Industrial Average



Source: Ned Davis Research.

Their rebound in the early 1930s was much more impressive than it looked; as stock prices went up in the rally from 1932–1937, the prices of everything else went down. The subsequent bear market from 1935–1942 was much worse than it looked, because a higher inflation rate in those years added to the losses. With inflation held in check from 1942–1968, stocks once again enriched investors as advertised.

The shocker on the Zweig chart comes from the 1970s. The raw Dow declined from Dow 1052 in 1973 to 777 in 1982, so on the surface, stocks lost 20 percent over that disappointing stretch. Adjusted for inflation, the actual decline was 75 percent, as shown on the chart. Government spending—on fighting poverty at home and the North

Vietnamese abroad—pushed inflation to its highest levels in the century: 9.25 percent annually per year for nine years.

Statistics are like prisoners under torture: with the proper tweaking, you can get them to confess to anything. Nevertheless, the numbers cited above lead to a few obvious conclusions:

- Periods of extreme inflation are lousy times to own stocks.
- Stocks aren't as profitable as most people think.
- If you accept the premise that stocks advance 10 to 11 percent over time, the recent fifteen years of exceptional gains won't be repeated in the next fifteen years.

The Case for Cutting and Running

"Buy and hold" have replaced "I love you" as the three most popular words in the English language.

Jim Grant

A NATIONAL PARK BROCHURE advises: "When you are approached by a bear, try to look big. Be forceful but not aggressive. Keep your pack on, wave your arms, talk loudly. Back away slowly, but DO NOT RUN. If a bear attacks you, assume the fetal position and protect your vital organs."

This is also the approved emergency plan for surviving a bear market: Assume the passive position and protect your vital assets, keep your shirt on, play dead with the broker, complain loudly if you must, but DON'T FLEE YOUR STOCKS OR ABANDON YOUR MUTUAL FUNDS.

No doubt you've been fully briefed on the merits of buying and holding. What investor hasn't? It's an article of faith that a representative sample of stocks, if held for the long run, can't fail to pay off. Otherwise, how did the Dow get from 40.94 when Dow created it, to 8,000? It's another article of faith that being completely invested in stocks will result in greater profits than being partly invested or—*perish the thought!—going* stockless for extended periods.

Under the buy-and-hold regimen, the price you pay for a stock or mutual fund at any given moment is of minor importance. "No price is too high to pay for good stocks" was the theme of a brokerage house ad campaign. As long as you traffic in reputable companies, and give them time to "grow" their earnings (five years is the suggested minimum), you'll be able to sell your shares for more than whatever price you paid for them.

But how long is the long run? The answer may surprise you. It could be longer than a stockpicking Methuselah had bargained for. John Maynard Keynes, the brilliant economist who wasn't brilliant enough to avoid losing millions of dollars in the bear rout of 1929–1932, said of his unhappy experience: "In the long run, we'll all be dead."

It took acres of cemeteries to bury all the investors who died waiting for their stocks and mutual funds (then called "investment trusts") to come back from that Great Decline. Senior citizens who entered the market in 1929 expired before their heirs broke even. A forty-year-old who got in near the top and held on for the duration didn't see a hint of profit until he reached retirement age, in 1954. By then, his hairline had suffered a correction, his paunch advanced, his children had left home, and he qualified for the elderhostels. The long-term view had kept him in stocks through Herbert Hoover, Franklin Roosevelt (four terms), Harry Truman, and two years of Eisenhower, *yet he had zero capital gains to show for it.*

In fact, his breaking even after a quarter century was only an illusion, because the U.S. dollar lost two-thirds of its buying power over that stretch. Bring inflation into the equation, and his $10,000 portfolio of Dow Jones Industrials acquired at the top in 1929 was worth $3,333 in 1954. So much for the guaranteed rewards from patient investing in reputable companies that grow their earnings.

Although you may suspect you have a knack for it, the odds of buying at the top of any market cycle are quite low. What happened, then, if you bought Dow Jones Industrials at a lower peak in 1927, enjoyed two years of paper profits, and then held on for the Great Decline? In *this case, better timing did you six years' worth of good.* You broke even in 1948 instead of 1954.

So you're looking at nineteen years of losses from buying near a top of a Great Decline, and twenty-five years for buying at an absolute top, but these dreary prospects are admittedly far-fetched. Experts dismiss the 1929–1932 bear market as a financial fluke. It resulted, they say, from "margin investors" buying stocks at 10 percent down and playing them like horses; meanwhile, greenhorns at the Federal Reserve made rookie mistakes that paralyzed the economy. Because the modern stock-player can't buy stocks on 10 percent down—and the modern, sophisticated Federal Reserve is too smart and too experienced to make rookie mistakes—the Great Decline can never be repeated.

A bear's eye view of the Great Decline (see page 238) is less reassuring, but, for the moment, let's accept the notion that the investor who pays top prices for stocks will never again suffer an 89 percent markdown like the one that hit the Dow. How long, then, did you wait to break even if you bought stocks at or near the more recent peaks? Consider these examples:

- The Dow climbed to 194.40 in 1937. It sold for less 12 years later, in 1949.
- After topping out at 685.47 in 1959, the Dow sold for less 17 years later, in 1974.
- The Dow moved into record territory at 734.91 in 1961, and sold for exactly the same price in 1980, 19 years later.

- The Dow hit 995.15 in 1966 and sold for the same price nearly 17 years later, in late 1982.

Even in the best of these worst-case scenarios, if you invested in stocks or stock mutual funds near a peak, you bought yourself a decade, perhaps two decades, of red ink. Or, if you were clever (or lucky) enough to buy stocks in a valley, you doubled your money on the next rise, only to watch those gains disappear on the subsequent decline, leaving you no richer than you were at the outset. For example:

- The Dow hit a low of 42.15 in November 1903. It hit a lower low of 41.22 in July 1932—29 years later.
- The Dow fell to 72.94 in 1911. It sold for less in 1932—21 years later.
- The Dow bottomed at 566.05 in 1960. It sunk to 577.60 in 1974, gaining all of eleven points in 24 years!

The long run gets longer when the ill-timed investment in stocks is compared to an investment in Treasury bills, savings accounts, or money market funds that pay interest. Such a comparison is hardly unfair—money that isn't riding on stocks has to go somewhere. Jim Stack has crunched these numbers.

Stack's a character. With full beard, steely gaze, and ready grin, he looks like the bear that ate the salmon. He operates out of Whitefish, Montana, on the outskirts of Glacier National Park, where hikers carry cowbells to keep the grizzlies informed of their whereabouts. A giant wooden bear guards the entrance to Stack headquarters—a split-level on Whitefish Lake.

His relationship with sagging stocks goes back to 1973–1974, when his IBM pension plan (he was a young research engineer) had a quick 50 percent correction and planted a skeptical seed that sprouted later. He bought Colorado real estate, made a pile, then left IBM to return to Whitefish, and put the pile in the stock market in 1982. There was no broker's office or investment club in this outback, no place to watch the tickertape, nobody to compare gains and losses with. Out of loneliness, he started the InvesTech market letter: bullish in the 1980s, bearish since 1994. With the help of his wife, Lisa, and eight employees, he continues to issue bearish warnings from the first floor of his split-level, under the shadow of the wooden bear outside.

Stack figures it takes seven and a half years for stocks purchased at the onset of an average bear market to catch up to cash parked in Treasury bills—even if the stocks pay a dividend. In a worse-than-average bear market, the breakeven point is considerably delayed. The twin bear markets of 1969–1971 and 1973–1974 demanded exceptional patience in that regard. Money riding on the Dow Jones Industrials in 1966 didn't catch up to Treasury bills until 1986. Money riding on small stocks, in Value Line's small stock index in December 1968, still hasn't caught up to Treasury bills.

Buying and holding is far from the sure thing it's made out to be. It works in bull markets. It works if you invest regularly, in dribs and drabs, catching the ups and downs along the way. It works in mild bear markets, when the declines are quickly reversed. It may work if you've got ten to twenty years to wait for stocks to recover from a half-off sale. Otherwise, it's risky. It's very risky when you're holding stocks you bought at extravagant prices. It's extremely risky when your retirement depends on a positive result and you're planning to take up golf in a decade or less.

The most celebrated buyers and holders in recent memory, Warren Buffett and Peter Lynch, aren't wedded to stocks unconditionally. Both agree that companies that are carefully chosen and purchased at favorable prices can generate excellent profits down the line. Neither buys and holds "the market" with index funds, as many investors do today. And there's a point at which they'd sell.

In 1969, when prices reached the luxury box and Buffett could find nothing worth owning, he disbanded his limited partnership, sold everything in the portfolio, and gave his partners their money back. In financial circles, this was unprecedented—not the selling, but giving the money back. During the bear market that followed, Buffett was hiding in cash. He returned to stocks four years later, when they were cheap.

Unfortunates who got in near the top couldn't see a clear profit through four presidencies. Buffett got in near the bottom and became a billionaire on the way up. Today, his holding company (Berkshire Hathaway) is too big to be converted to cash, although Buffett may wish he still had that option. At the annual meeting in 1997, he told shareholders it was hard to find a stock worth buying—the first time since 1969 he had reached that bearish conclusion. Earlier, he even said his own Berkshire Hathaway wasn't worth buying at the high price of the moment.

Lynch steered the Fidelity Magellan fund to a record-breaking performance through good markets and bad. For most of the trip, his portfolio was loaded with stocks, but not always. At one point, his biggest position was bonds, even though as a general rule he shunned bonds. Now retired from Magellan and a devoted fund-raiser for charitable causes in Boston, Lynch keeps an eye out for the conditions that trigger the Lynch sell signal:

> When the yield on the thirty-year government bond exceeds the yield on the stocks in the S&P 500 Index by more than six percentage points, sell stocks and buy bonds.

If Peter Lynch has a selling point, and Warren Buffett once had a selling point, should you have a selling point? Buy stocks in the long run, yes, but what will you do on those occasions when it pays to be out of them? If you decide to hold on as prices begin their slide, can you summon the extraordinary courage required to stay fully invested all the way down and back up again? And do you have the time?

Buy, Hold, or Fold

An investor in a panicky market faces the same predicament as a moviegoer in a crowded theater after somebody shouts "Fire!" Staying put is the sensible thing to do, as long as everybody else stays put and stays calm. Otherwise, people who stay put run the risk of getting trampled, and people who rush to the nearest exit may have the best chance of escaping unhurt.

In a burning movie house, staying put is easier said than done; and in the deep woods, when a bear's bearing down on you, playing dead gets progressively more difficult. It's one thing to assume the passive position when the danger's a half-mile away, and quite another when it's at fifty yards and closing. Likewise, when a $100,000 portfolio turns into a $95,000 portfolio, almost anyone can summon the courage not to sell stocks; but when it becomes a $75,000 portfolio, and your investments are making you poorer by the day, you have to be either brave or oblivious to refrain from calling your broker with a sell order.

The very existence of bear markets proves that long-term investors become short-term investors. A bear can't materialize without large numbers of sellers, so a broad decline in stocks can mean only one